VISIT…

How to avoid getting shaken out/faked out on Level 2: using your charts to confirm trade entries and exits (stochs, MACD, RSI etc.)

Main Points:

- Some market makers like HRZG MASH often show ridiculous bid sizes (eg 58, 104 etc) to give the false impression that there is buying strength in the stock. As soon as people start to hit their bid they often vanish (drop back a spread or two). You say "wow I thought there was a ton of buyers, where did they disappear to? These are common mm tricks to panic new daytraders out of their positions. Let's fight back, ok?

- Other times, as we saw in earlier lessons, a mm will pretend to be a seller when he's really buying a boatload on ISLD or INCA. The way, as always, to tell the truth of the situation is to follow the momentum in Time and Sales - this tells you the genuine directional flow of the stock price.

- A general rule of thumb to repeat: stocks that are heavily traded primarily on ECN's (where you see a lot of ISLD INCA ARCA action in the inside bid/ask instead of the big mms MSCO GSCO SBSH MLCO) are not as easy to anticipate and follow using level 2; I find level 2 is more useful for stocks that have active participation by the big mms. For these ECN-traded stocks (eg DCLK) I find the one-minute chart is the most useful tool. I still watch L2 of course, but it does not play as big a role in helping me to decide whether to get in a trade or not.

- Some of the stocks for which L2 has been particularly worthless to me include WCOM, INTC and MSFT; yet another reason to avoid the "most actives" when it comes to daytrading. Why? In these stocks, the bid/ask columns are usually 5-12 participants wide and there is seldom any clear direction for net buying/selling. Of course, the T&S is still very useful here, as is the 1-minute chart.

Avoiding Fake-Outs on Level 2

Examples:

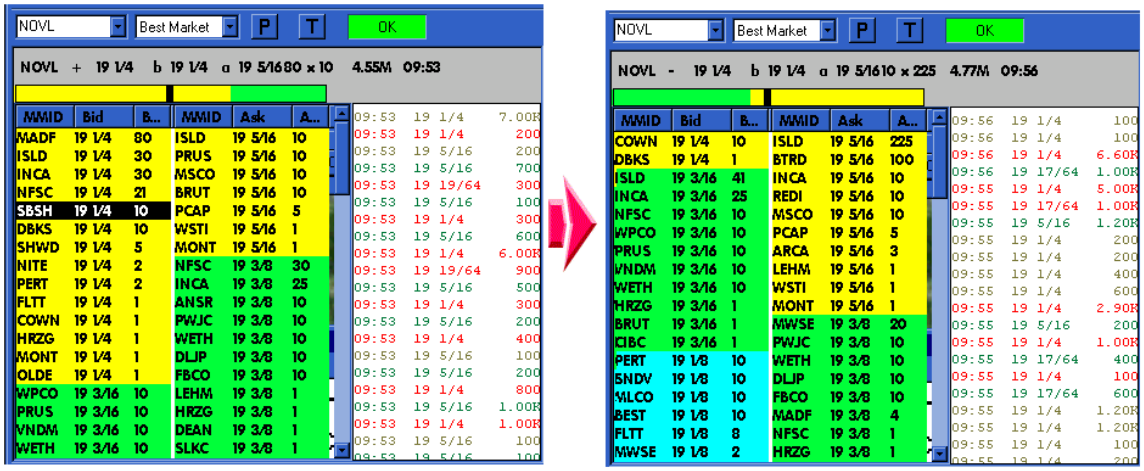
If you had made the common new trader's mistake of just relying on Level 2 in the example below, you'd have been wrong. Look at the price action and time: in just 3 minutes (from 9:53 to 9:56) the 1/4 bid evaporated and the stock started selling off.

Look at the Level 2 box on the left: it looks like the price may go up, right? There's a lot of bidders compared to sellers. Now look at the Level 2 box on the right: just 3 minutes later and nothing but sellers. Fake-out!

How did this happen, you ask? Hopefully you didn't pay retail at 19 5/16 and sell back at 19 3/16 or lower once it started dropping; that's how professionals take your capital away.

Quiz: There's TWO CLUES THAT SHOULD HAVE KEPT YOU OUT OF THIS TRADE. What are they?

(Answer below)



Answer:

1) **Time and Sales** shows primarily selling action, a lot of trades going off at 19 1/4, including the block trades of 6K and 7K shares. Very bearish sign.

2) **Weak bidders vs sellers**: MADF (a small mm) and ISLD/ARCA bidders are weak. When you look at T&S you see that over 3K shares have been bought from ISLD at 19 5/16, yet the ISLD book is still strongly weighted to sellers, it didn't disappear; telling you that the depth of sellers on ISLD at 5/16 is heavy. Also, MSCO is right under the ISLD/PRUS asks, and he's a strong market maker.

Daytraders' Play: Keep your eye on the ball, which is Time and Sales, and the 1-minute chart. I'd look to buy this stock off 19 support, maybe put my bid in at 19 1/16 and have a stop at 18 15/16.

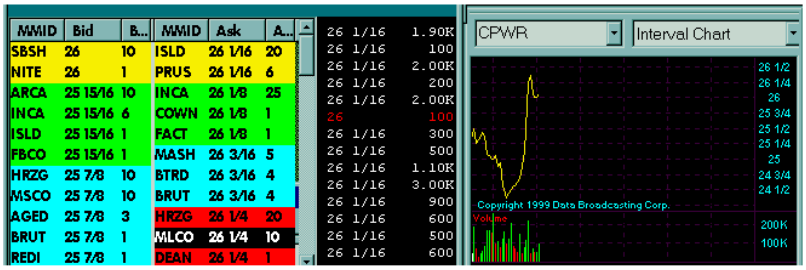
Stops: Again, mm's know that most traders set their stops at whole numbers and large fractions (1/4 3/8 1/2 5/8 3/4 etc). Use stops **1/16th under where the mm's drop the stock to** at these major whole numbers and fractions. For decade support/resistance, you might want to increase this to 3/16ths stops. Follow the major mm's closely for these plays.

Example #2: In this CPWR L2 window and chart below, what do you see going on?

A lot of buying at 26 1/16th; even though it's ran up 1 1/2 points off it's bottom, Time & Sales is telling us there's still plenty of buyers of this stock at 26 1/16. Also, since SBSH is on the bid (bullish) and only ISLD is on the ask (could be anyone, no direction indicated), It might be safe to enter a trade by bidding 26 1/32 or enter a buy 1100 CPWR at 26, frontrunning SBSH.

At this point in the trade, you missed most of the major momentum, and are looking for either incremental **scalps** (eg I'd scalp this to 3/16 - 1/4 max expectation), **or short** if it loses 26, for a short scalp down to the 5/8-3/4 support. Again, tempered by overall market direction - if it's a runaway bull market then I may stay in the trad a bit longer. If it's choppy or down, I'll be very cautious on any long positions and look to scalp only.

Declining volume that you see is also a bearish indicator, we may see some weakening of the stock, unless a major mm steps in to buy more. Note that sell volume was higher than the buy volume, and the buying ran up very quickly (weak high here), so again, cautious long even with a bullish tape; be prepared to fire off a sell (or short) if we drop back to 15/16.

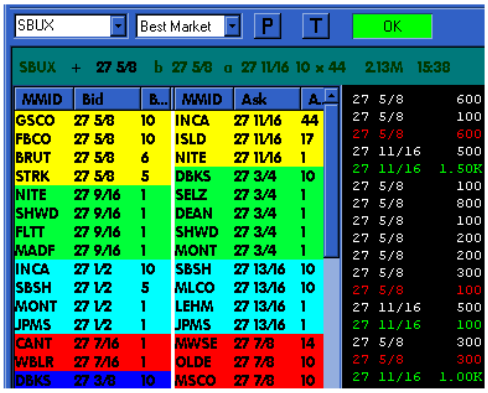


Example #3: The old "Trying to look like a buyer when you're really selling a boatload trick" (say that in your favorite Maxwell Smart voice). "Missed it by That Much".

Well, anyways, let's look at the L2 window below. What is MADF doing, buying or selling? Would you believe, "Selling"? No? Ok, how about "Looking like a buyer when he's really selling 50,000 shares on INCA"? (perhaps). It's hard to tell, all we know for sure is that GSCO is really buying since his bid is firm at 27 5/8 as seen by the tape action.

MADF, Even Though he's on the 2nd outside bid, he may be selling on INCA. So could FBCO and BRUT, for that matter. What we need to always monitor is the tape and the bid/ask size: are they staying the same? (indicating refreshed orders, impossible to tell the depth/order flow), or are they shrinking/getting bigger?

Daytrader's Play: Looks like they're selling it for now, you might want to put in a bid for the stock at 27 1/2 and wait for a bounce, or sit it out until the tape shows clear direction of selling resuming.



In Summary, there are a few new points worth remembering about Level 2:

- It should never be used as a primary direction/trend decision-making support tool

- It is useful to monitor your precise entry and exit timing, when used in combination with 1-min chart and T&S

- MMs will either a) flip from the bid to the ask or b) change the parameters of their "trade box", (eg where exactly they're bidding and offering the stock out at), when they believe the stock will change direction, you should be on the side of these major players when you see it happen.

- MMs will use Level 2 to advertise false and misleading bid/ask sizes to panic out and whipsaw the inexperienced trader

- L2 is useful as a trading tool only as a specific entry/exit indicator once T&S and TA has confirmed the direction or pivot point of the trade you want to enter. Eg, if both the major sellers of SBUX got taken out above (this time its ecns: ISLD/INCA) and NITE is alone on the ask, and T&S shows lots of trades going off at the ask, then you might want to pay up and buy retail at 27 11/16.